National Intelligence Officers

24 Jan 1979

MEMORANDUM FOR: DCI

THROUGH : D/NFAC

Attached is the warning memo you requested from Hans Heymann. You will note Hans' reservations with regard to making this a monthly exercise. I think he is probably right as far as the memorandum is concerned, but I believe the monthly discipline of sitting down with D/OER and D/ORPA to consider whether a memo should be written is highly desirable and should be continued.

Richard Lehman
NIO for Warning

Attachment

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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D. C. 20505

National Intelligence Officers

NFAC No.0391-79
23 January 1979

MEMORANDUM FOR: Director of Central Intelligence

VIA : Deputy Director for National Foreign Assessment

: National Intelligence Officer for Warning

FROM : Hans Heymann, Jr. H
National Intelligence Officer for Political Economy

SUBJECT : Warning Memorandum: Global Implications of Loss of Iranian Oil

1. You expressed an interest in receiving a warning memorandum from NIO/PE. After considerable discussion with D/OER and D/ORPA, we concluded that issues in the global political-economic sphere do not readily translate into the "warning" format adopted for this new art form. Almost all critical political-economic issues are country- or region-specific and, therefore, covered by the regional NIOs. In rare instances, local or regional issues will have serious global repercussions. The Iranian crisis is such a case, because of the potentially pervasive effect of the interruption of the oil supply. While this issue has already received attention, we felt it would be useful to devote a warning memo to a more systematic look at the possible spillover effects of the Iranian crisis, concentrating on the oil market and the world economy. Its sole purpose is to put into perspective for the policymaker some of the unpleasant possibilities that he may face. 25X1

2. We will continue to be alert to future opportunities for "warning" in the global political-economic arena, but we doubt that it would be useful to attempt to provide such warning memoranda on a regular basis. We hope you concur. 25X1

3. This memorandum has NIO/NESA, ORPA and OER concurrence and has been circulated to Treasury and State for comment. 25X1

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[redacted] 25X1

NFAC No. 0391-79
23 January 1979

MEMORANDUM FOR: Director of Central Intelligence

VIA : Deputy Director for National Foreign Assessment

: National Intelligence Officer for Warning

FROM : National Intelligence Officer for Political Economy

SUBJECT : Warning Memorandum: Global Implications of Loss of Iranian Oil

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(23 January 1979)

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NFAC No. 0391-79
23 January 1979

WARNING MEMORANDUM

Loss of Iranian Oil: Some Global Implications for 1979

Any consideration of the uncertainties surrounding future trends in Iranian oil output clearly raises the specter of global market stringencies. It is even conceivable that later this year the world will face economic hardships and political tensions reminiscent of the 1974 OAPEC/OPEC induced crisis. Given the seriousness of these possibilities, their nature and ramifications should be carefully considered. As a first step, this memorandum describes possible trends in the global oil market this year and examines the problems that would be created by an oil export shortfall. No attempt is made to predict events; indeed, many of the possibilities discussed may be remote.

Potential Oil Market Problems in 1979

While the global oil market will probably be able to cope with an Iranian oil shortfall in the first quarter of 1979, problems could arise soon thereafter. From spring through summer, oil stocks are usually rebuilt, in contrast to the drawdowns that normally take place during the first quarter. In addition, by spring, OPEC oil production facilities, especially those in Saudi Arabia, will have been strained from months of running at near full capacity.

Although the current uncertainties in Iran make it impossible to predict oil market trends, we can at least examine the range of possibilities. Three plausible scenarios can be envisaged, ranked here in order of increasing risk that serious market stringencies will appear between April and the end of this year.

Slight Risk - Iranian oil production is substantially restored by spring. Although fears of a supply shortage would ease, the necessity to rebuild stocks to normal levels would leave the market susceptible to any renewed curtailment of Iranian (or deep cuts in Saudi) output. (This case assumes that a new government in Teheran believes it needs maximum oil revenues to restore economic activity in Iran and/or desires to continue the modernization effort, albeit at a somewhat reduced rate.)

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Moderate Risk - Iranian output averages some three million b/d. Under this scenario market conditions would remain tight even if non-Iranian production remained at current high levels. Thus almost any prolonged sharp drop in output of the other major producers could produce a supply crisis. (This case assumes that the successor government abandons much of the Shah's modernization program but sells enough oil to sustain at least a modest standard of living for the populace.)

High Risk - Iranian oil output remains below one million b/d for most of the period. (This case would stem from either prolonged civil disturbances reflecting continued governmental incapacity, or from the installation of a highly fundamentalist regime which seeks deliberately to isolate the country as completely as possible from foreign influences.)

The above depiction of a range of possibilities suggests that, under all but the most optimistic circumstances, the world market faces a substantial probability of oil stringencies appearing later this year. With tight market conditions, sharp production cuts by any important producer for any reason would cause a considerable price run up. It must be strongly emphasized, however, that the timing of a market crunch, if there is one, will depend more on the behavior of oil consumers and marketers than on projected demand/supply trends. Once these groups believe that they will be unable to replenish stocks, they will be more inclined to hold onto or, even worse, build inventories rather than draw them down. This would make consumption cutbacks necessary earlier than stockpile levels would indicate.

Danger Points and Some Possible Opportunities

Higher Prices Combined with Slower Growth - Without nearly full resumption of Iranian oil production by spring, the odds are high that OPEC oil prices will rise beyond these decided at last month's meeting of the organization. These probabilities climb from near-even with Iranian output averaging 3 million b/d, to almost-certainty under the one million b/d scenario. Any OPEC price hawk could lead the way by unilaterally raising prices above the official level. Those countries producing mainly light crudes could achieve higher unofficial prices by hiking the quality differential between light and heavy crude. Higher prices could also be set officially at an OPEC meeting, and Saudi Arabia -- because it is already operating at near-capacity -- would have little power beyond moral suasion, to hold the line.

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A substantial increase in oil prices would, of course, depress expected economic growth. As was the case in 1973, the United States is now attempting a so called "soft landing", whereby the economy would slow somewhat in order to relieve inflationary pressures. With much higher energy prices, the landing could again be "hard", with inflation rates remaining uncomfortably high. The economies of Western Europe are in the best position since the 1975 recession to accelerate economic expansion. Sharp hikes in oil prices would nip this opportunity. Japan, already beleaguered by the difficulties of turning its economy inward and the most dependent on oil imports, may find its economic growth particularly hard hit. In all developed economies, the economic cushion provided by exports to OPEC would certainly be less than in 1974 and 1975. Although OPEC states would once again have vastly increased spending power, only a few would greatly expand foreign purchases.

The troubles among developed countries would inevitably spread to the LDCs. The payments positions of many LDCs, especially "upper tier" ones, are expected to weaken substantially this year, and higher oil prices combined with lower exports to the developed world would unquestionably make conditions worse. The poorest countries would be asking for more aid at the very time the developed countries could least afford such outlays. If the oil price hikes come this spring, they would affect the tone of both the UNTAD V conference in May and the Tokyo Summit in June.

The Saudi Arabian Factor - The pressures facing the Saudi leadership have intensified as the Kingdom's oil export level has increasingly become the critical arbiter of global economic health. This has happened at a time when its latent succession problems are beginning to emerge, its faith in the value of its alliance with the United States is being questioned and its misgivings about sustaining near capacity oil production are sharpening. The Saudis will face the dilemma of having to exert more influence, while feeling more vulnerable. They will be urged, and may be tempted, to use their oil supply leverage to achieve objectives in the Arab-Israeli arena. At the same time, their perceived dependence on their long-time ally, the United States, will deepen, as the uncertainties in Iran add to their anxieties (felt by the Saudi establishment) over the growing Soviet involvement in the region. Given these circumstances, the possibility exists -- at least in principle -- for some trade-off between the future level of Saudi oil output and US security guarantees. If the US extends, and the Saudis agree to, such an arrangement, it might be possible to convince the Persian Gulf sheikdoms, Kuwait and the UAE, to participate in such an accord. The accord might include a provision for temporarily lifting self-imposed production ceilings, a move which would add more than one million b/d to global oil supplies.

[redacted]

Non-Price Reactions by Oil Exporting States - Some oil producing states may also try to advance their perceived political and economic interests other than through higher oil prices. These could range from efforts by a single state (e.g., Mexico) to link increased oil exports to US trade concessions or US treatment of migrant labor, to efforts by a group of states (e.g., Arab oil producers) seeking to influence the course of development of a settlement with Israel. The scope of action could range from the most subtle verbal hints to open threats of concrete action, such as a limitation on production.* In most cases, however, their actual leverage will be limited. Oil producers will have to cope with weaknesses such as OPEC members' unwillingness to halt the flow of oil for fear of losing needed foreign exchange. Also, each producer will have to weigh any such action in the context of its overall foreign relations.

Competition Among Importing Countries - Competition for oil on the world market could lead to tensions between consumers, especially the United States and its OECD partners. These intra-OECD strains, however, may be significantly less than in 1973-1974. Governments have learned from the earlier experience that a scramble for oil supplies is self-defeating, in that it needlessly drives up prices and leaves the buyer stuck with high-priced oil contracts once supply conditions return to normal. In addition, the International Energy Agreement, adopted by 18 member countries, provides at least a framework for allocating available supplies of imported oil. It has never been tested under actual conditions, however, and it is questionable whether it could function effectively in the context of severe oil stringencies.

A Change in US-Israeli Relations - Israel's sense of insecurity and isolation has already been heightened by the loss of Iran as an ally and oil supplier. This may stiffen its determination to be self-reliant, making a peace settlement more difficult. At the same time, possible oil market stringencies later this year may force Tel Aviv to invoke its oil supply agreement with Washington. A flow of US oil to Israel would come just at the moment when the United States may have to impose domestic restrictions to conserve oil.

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* We have received one report that the Nigerian leadership is giving more serious consideration to using oil as a political weapon than it has in the recent past. Lagos is heavily dependent, however, on oil sales to finance its domestically important development program.

[redacted]

Reaffirmation of the Plutonium Economy - The Iranian oil cutback will strengthen the convictions of those who favor additional R&D on plutonium-based reactor systems predicated on reprocessing. Rapidly rising oil prices would certainly reinforce their position, further complicating US efforts to stall the development of these plutonium-based systems.

* * * *

A Serious Global Financial Crisis? - This is a large and complex issue that should be discussed separately. So far the international financial consequences of Iranian instability have been minimal largely because Teheran has such a large cushion in the form of foreign exchange reserves outside of Iran. More serious problems could emerge in the next few months, however. While these could hurt individual banks, the international financial system is able to cope. We do see one remote possibility with wider ramifications. A fundamentalist regime in Iran might decide to abrogate its foreign debts, on grounds they were the product of the Shah's "illegalities". Some Western banks with a large Iranian exposure and a weak financial structure could go under. A chain reaction is then possible if the banks concerned are deeply involved in the unregulated euro-dollar market.

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